STAFF REPORT
OV05043092

INTERIM RATE REDUCTION

November 27, 2006

1. Introduction and Overview

The interim rate reduction is based upon the facts that title insurance premiums and escrow charges are generally calculated on the basis of the size of the transaction – sales price of the home or amount of the real estate-secured loan – and that, as home prices appreciate for a particular transaction, title insurers and escrow providers receive more premium and fees without raising title insurance or escrow rates.

Consider the following example. The basic title premium charge by First American Title Insurance Company in 2000 for a $250,000 extended coverage owner's policy was $1,274.38. Let us assume that the home is sold the next year in a rapidly appreciating home sales market for 25% more. The same type of title policy – now based on a transaction amount of $300,000 – costs $1,440.00 or an increase of 13% in one year. Since the amount of the premium actually tied to the transaction amount (loss exposure) is a very small portion of the title insurance premium (around 5%), the reasonable cost of providing the second policy has not increased by $165.63, or 13%, in one year.

California's rapidly appreciating housing market since 2000 has resulted in windfalls for the California title and escrow industry because title and escrow rates are tied to real estate transaction size. Based on actual transaction data provided by DataQuick, the average and median sales prices of homes has jumped since 2000, as have the resulting average title insurance premiums and escrow charges. Table 1 shows changes in statewide average transaction size and statewide average title premium by transaction type. Table 2 shows changes in regional average transaction size and regional average escrow charges by transaction type

Table 1
Change in Title Insurance Average Premium and Average Transaction Size in California, 2000-2006

	Title Non- Purchase	***Title Purchase***
2000 Average Premium	$444	$1,069
2006 Average Premium	$589	$1,708
2000 Average Transaction Size	$114,178	$275,261
2006 Average Transaction Size	$235,318	$542,683
Change in Average Premium	133%	160%
Change in Average Trans Size	206%	197%

Table 2
Change in Escrow Average Charge and Average Transaction Size in California, 2000-2006

	Escrow Non-Purchase			*Escrow Purchase*		
State or Region	***South***	***Bay Area***	***Rest of State***	***South***	***Bay Area***	***Rest of State***
2000 Average Premium	$439	$323	$275	$1,044	$714	$490
2006 Average Premium	$601	$432	$375	$1,558	$881	$738
2000 Average Transaction Size	$108,159	$153,038	$81,018	$257,625	$438,176	$193,434
2006 Average Transaction Size	$239,180	$279,742	$190,595	$550,022	$693,233	$421,909
Change in Average Premium	137%	134%	136%	149%	123%	151%
Change in Average Trans Size	221%	183%	235%	213%	158%	218%

The interim rate reduction addresses this "premium trend" by requiring rates be reduced from 2000 levels to produce reasonable title insurance premium and escrow charges after consideration of the rapid increase in transaction size. The basic approach is to take the actual 2000 average premium for a specific type of transaction, increase a portion of the premium for actual inflation from 2000 to 2006, increase the loss provision to reflect the increase in liability due to increased transaction size, add these two values and gross this sum up by variable expenses. The resulting value – the reasonable title insurance premium or escrow charge in 2006 based on 2006 transaction values – is then compared to the actual 2006 average premium or escrow charge to determine the reduction in 2000 rates necessary to produce the reasonable 2006 average premium or escrow charge. Current rates are then compared to the interim-rate-adjusted 2000 rates and, if not already below that level, the current rates must be reduced to levels that do not exceed the interim-rate-adjusted 2000 rates. Table 3 shows the calculation of the interim rate reduction for title purchase transactions.

The term "rate" is used to describe the charge to the consumer per unit of exposure, typically expressed as a dollar charge per $1,000 of transaction size. The title insurance premium charged a consumer is the result of the rate applied to that consumer's transaction size. Similarly, the escrow fee or escrow charge for a particular consumer is the result of the escrow rate applied to that consumer's transaction size. Since premium is generally understood as an insurance term, we refer to the amount of title insurance charge as title insurance premium. We avoid referring to escrow charges as premium because escrow services are not insurance and, instead refer to the amount of escrow charges as escrow fees or escrow charges. We refer to title insurance rates and escrow rates to describe the respective charge per unit of exposure.

Table 3
Calculation of Interim Rate Reduction for Title Purchase Transactions

1	2000 Average Title Purchase Premium	$1,068.85
2	2000 to 2006 Inflation	13.71%
3	Portion of 2000 Premium Subject to Inflation	75%
4	Inflation-Adjusted Premium Share: (3) * (1) * (1.0 + (2))	$911.54
5	Percentage Portion of Premium for Claims	5%
6	Dollar Portion of 2000 Premium for Claims: (5) * (1)	$53.44
7	2000 Average Transaction Size	$275,261.23
8	2006 Average Transaction Size	$542,683.34
9	Percentage Increase in Transaction Size: (8)/(7)	197%
10	Transaction Size-Adjusted Loss Provision: (9) * (6)	$105.36
11	Variable Expense Portion of Premium	20%
12	Indicated Reasonable 2006 Premium: ((4) +(10))/(1 - 11)	$1,271.13
13	2006 Average Premium	$1,708.19
14	Interim Rate Reduction: ((12)/(13))-1	-25.6%

Tables 4 and 5 summarize the interim rate reductions for title insurance and escrow.

Table 4
Title Insurance Interim Rate Reductions

Transaction Type	***Title Interim Rate Reduction***
Title Purchase	25.6%
Title Non-Purchase Refinance	-9.8%
Title Non-Purchase Other-Than-Refinance	-15.4%

Table 5
Escrow Interim Rate Reductions

	Escrow Interim Rate Reduction		
Transaction Type	***Bay Area***	***South***	***Rest of State***
Escrow Purchase	-7.4%	-23.0%	-23.6%
Escrow Non-Purchase	-14.5%	-15.9%	-15.4%

A sales price adjustment factor is a potential modifier to the interim rate reduction in the event of flattening or reduction in transaction size from 2006 – the period used to determine the interim rate reductions – to 2009 – the start of the period the interim rates become operational if the Commissioner is unable to implement the maximum title and escrow rate prescribed in proposed Sections 2357.5 and 2358.4, respectively.

The sales price adjustment factor effectively calculates a reasonable 2009 interim reductions in the same manner as the 2006 values, substituting estimated 2000 to 2009 inflation factor, estimated 2000 to 2009 change in transaction size and estimated 2009 average title premium or escrow charges for the 2000 to 2006 counterparts. If the interim rate reduction based on 2009 data is less than interim rate reduction based on 2006 data, as presented in Table 3, the interim rate reduction is reduced. The interim rate reduction may not be increased, even if transaction sizes appreciate rapidly by 2009. The interim rate reduction may be eliminated – become zero – but may not become a rate increase through the sales price adjustment factor.

2. Discussion of Data and Assumptions

2.1 Average Premium Calculations

The average premium calculations were based on the actual real estate transactions in calendar year 2000 and the 12-month period from October 1, 2005 through September 30, 2006 as provided by DataQuick after eliminating any transactions reported with a zero dollar ($0) transaction size. Separate calculations were performed for purchase transactions and non-purchase transactions, reflecting the two data sets provided by Data Quick. Zero dollar transactions were removed for three reasons. First, DataQuick advised that such transaction reports were incorrect and likely reflected very large transactions in which the participants sought privacy by not reporting the transaction size. Second, there is no title insurance liability for a zero dollar transaction and, consequently, no rationale for a title policy to be issued. Third, zero dollar transactions appeared to have already been eliminated in some data sets. Appendix 1 shows the impact of eliminating zero transactions on the statewide number of transactions, statewide average transaction size and title interim rate reduction. While arguments can be made to use other filters – such as eliminating transactions of $25,000 or less from the purchase data set as DataQuick does when it publishes its monthly median sales report – the zero dollar filter was used for consistency across all types of title and escrow transactions and because zero dollar transactions do not reflect the actual size of the transaction reported.

2.1.1 Title Insurance

Six average premium calculations were performed – title purchase, title non-purchase refinance and title non-purchase other than refinance in 2000 and in 2006. For title purchase transactions, five premium charges were calculated based on the 2000 rate filings for an owners policy purchase transaction for the following five title insurance companies – First American, Chicago, Fidelity National, Lawyers and Old Republic.

An average premium for the transaction was then calculated by applying the relative market shares of the five title insurers, which were based on 2004 data reported in the underwritten title company annual reports to the Financial Analysis Division of the California Department of Insurance. Relative market share means the title insurance company's share of the total market share represented by the five title insurance companies.

The average of all individual transaction average premium charges is the statewide average title insurance premium shown in Table 1. The calculation was performed for the 2000 data set and the 2006 data set.

The calculations for title non-purchase refinance are similar with non-purchase transactions. The two differences are, one, use of the non-purchase data set, and, two, use of loan policy rate tables for non-purchase other than refinance and use of refinance rate tables for non-purchase refinance.

2.1.2 Escrow Charges

The calculation of average escrow charges was similar to that for average title insurance premiums with the following differences:

- Escrow purchase rate tables were used for escrow purchase and escrow loan rate tables were used for escrow non-purchase.
- Average charge per transaction was calculated on the basis of county market share of the escrow providers reporting experience in the county in the underwritten title company annual reports submitted to the Financial Analysis Division of the California Department of Insurance.
- The average charge and average transaction size was calculated for three sub-state regions, based on all transactions – purchase or non-purchase – within that region.
- Escrow rates were used for Chicago Title Insurance Company, Commonwealth Title Insurance Company, Fidelity National Title Insurance Company, New Century Title Company, Old Republic Title Company and Stewart Title of California, Inc.

2.2 Selection of Transaction Types and Geographic Region

The interim rate reductions for title insurance are broken out by three sets of transaction types – purchase, non-purchase refinance and non-purchase other than refinance. The reductions are uniform statewide, consistent with the fact that title insurance rates are uniform across the state. There are no county-specific title insurance rates, with the exception of smaller minimum charges in a few small counties.

The interim rate reductions for escrow are broken out by three regions and two sets of transaction types. The transaction types are purchase and non-purchase. Non-purchase is not broken out into refinance and other than refinance, as with title insurance interim rate reductions, because not all companies utilized a separate refinance fee schedule from the loan fee schedule in 2000. Geographically-differentiated escrow interim rate reductions are used because escrow rates vary by county and by sub-county areas and because the growth in average transaction size varied by region in California over the 2000 to 2006 time frame. Based upon an analysis of changes in transaction size and change in average premium by county, counties were placed into one of three groupings – South, Bay Area and Remainder of State. Appendix 2 shows the region each county is place into for purposes of the escrow interim rate reduction.

2.3 Interim Rate Calculation Assumptions

2.3.1 Loss Provisions

A loss provision – which is subject to increase at the same rate as the increase in transaction size – of 5% was used for title interim rate reductions and 1% for escrow interim rate reductions. These amounts are based on the long-run average for title insurance and on escrow loss reports filed by underwritten title companies with the Financial Analysis Division of the California Department of Insurance, respectively.

2.3.2 Variable Expenses

A variable expense provision – expenses that vary with the size of the premium or escrow charge – of 20% was used to reflect a reasonable sales and marketing expense of 15% of premium and an average profit provision of 5% of premium.

2.3.3 Portion of Premium Subject to Inflation

The remainder of premium – 75% for title insurance and 79% for escrow – was the amount to which inflation was applied to transform reasonable 2000 expenses to reasonable 2006 expenses. The amount subject to inflation is the residual left after subtracting the provisions for losses and variable expenses. The escrow portion of premium subject to inflation is higher that the corresponding title portion because the escrow loss provision is 1% compared to 5% for title.

2.4 Inflation Series

The interim rate reduction analysis relies upon the countrywide chained consumer price index for urban areas, not seasonally adjusted. The Bureau of Labor Statistics (BLS) publishes a variety of consumer price indices. BLS user notes accompanying the various indices explain why the use of local CPI indices and seasonally adjusted indices are not appropriate for escalator clauses.

> *BLS annually reestimates the factors that are used to seasonally adjust CPI data, and seasonally adjusted indexes that have been published earlier are subject to revision for up to 5 years after their original release. Therefore, unadjusted data are more appropriate for escalation purposes.*
> .. . . . .
> *As a result, local area indexes are more volatile than the national or regional indexes, and BLS strongly urges users to consider adopting the national or regional CPIs for use in escalator clauses.*

The not seasonally adjusted series was selected to avoid the problems identified by BLS and to avoid seasonal mismatch problems for the inflation value used in the interim rate analysis versus the inflation value used in the sales price adjustment factor. The use of local indices was rejected because of the problems identified by BLS. The use of the countrywide index was selected over the Western regional index because there is no reason to believe that California is more similar to the other states in the Western region than to states outside the region. The countrywide index was also selected because the chained CPI is only available on a countrywide basis.

The chained CPI differs from the traditional CPI, as explained by the BLS as follows.

> *Because the geometric mean formula is used only to average prices within item categories, it does not account for consumer substitution taking place between item categories. For example, if the price of pork increases relative to the prices of other meats, shoppers might shift their purchases away from pork to beef, poultry, or fish. The traditional CPI formula did not reflect this type of consumer response to changing relative prices. In 2002, as a complement to the CPI-U and CPI-W, the Bureau produced a new index called the Chained CPI-U (C-CPI-U). The C-CPI-U was created to more closely approximate a cost-of-living index by reflecting substitution among item categories.*

The chained CPI was selected as a better measure of increases in expenses than the traditional CPI.

The inflation value was calculated from the midpoint of calendar year 2000 – the June 2000 value – to the midpoint of the 12-month period from October 2005 through September 2005 – the March 2006 value.

3. Sales Price Adjustment Factor

The calculation of the 2009 component of the sales price adjustment factor is similar to the calculation for the interim rate reduction. There are two key differences. First, the inflation value is based on the most currently available information in 2009 compared to actual inflation through the relevant period in 2006.

Second, the change in transaction size is based on a forecast of median existing home sales prices to be published by the California Association of Realtors (CAR) for 2009 compared to CAR's report of the median existing home sales price for 2000. The use of CAR data – which are based on median prices as opposed to average transaction size used in the interim rate reduction – requires the use of a factor to covert changes in median existing home sales price to changes in average premium. Appendix 2 summarizes the information used in both the interim rate reduction and sales price adjustment factor calculations.

The CAR median existing sale price report and forecast are used for the sale price adjustment factor because the data are publicly available and include a forecast as opposed to just historical data. The change in median existing home sales price as reported and forecast by CAR are a reasonable estimate of the percentage change in transaction size for the various transaction types and regional values. CAR also reports median existing condo sales price, but those values were not used to somewhat offset the absence of new home sales price information in the CAR data.

4. Changes from July 2006 Analysis

The following principal changes were made to the interim rate reduction analyzes from the July 2006 staff report.

4.1 Title Insurance

The calculation of average premium in the July 2006 report was an average of county average premiums. The revised analysis uses the statewide average premium – the average of all transactions in the state – to better reflect the transaction volume in individual counties and to better accommodate the sales price adjustment factor, which is based on changes in statewide transaction size.

The period from October 2005 through September 2006 was used in the revised analysis instead of the November 2004 through October 2005 data used in the July 2006 report to utilize the most currently-available data.

The transaction types were increased from title purchase and title refinance in July 2006 to title purchase, title non-purchase refinance and title non-purchase other than refinance in the current analysis to better reflect differences in refinance transactions versus other non-purchase transactions.

4.2 Escrow

The July 2006 escrow analysis was based on a sample of 200 transactions. The revised analysis is based upon all non-zero dollar transactions provided by Data Quick. The current analysis utilizes the rate filings of more escrow providers than the July 2006

analysis. The current analysis provides regional interim rate reductions versus a statewide interim reduction in the July 2006 report. The current analysis has separate interim rate reductions for purchase and non-purchase transactions compared to one interim rate reduction for all escrow transactions in the July 2006 analysis.